

Construction- USA

Pass-Through Claims in Construction Litigation

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Introduction

Subcontractors that have claims for economic damages against prime contractors frequently enter into agreements to pass those claims through the contractor in order to carry out a joint prosecution with the contractor against the project owner. These pass-through (or liquidating) agreements have been embraced in the United States for their ability to:

- allocate potential liability efficiently;
- avoid duplicative litigation; and
- prevent owners that would otherwise be insulated from subcontractor claims from receiving a windfall.

Although an agreement between two parties, with one potentially liable to the other, to pass that potential liability through to a third party may seem straightforward, the successful use of pass-through agreements in construction litigation requires careful consideration of numerous practical and legal issues.

Benefits

Pass-through agreements can be utilized to resolve disputes in any situation where one construction project participant has contracted with two others which are themselves unable to bring direct claims against one another due to their lack of contractual privity. These agreements are most often found in situations where a subcontractor which is unable to assert claims directly against a project owner is left with no recourse but to bring its claims against the prime contractor with which it contracted. In situations where the owner caused the subcontractor to sustain the damages in question, the prime contractor may find itself in the unenviable position of having to defend the owner's actions in order to defeat the subcontractor's claim, while simultaneously prosecuting a practically identical claim against the owner for its own damages.

Pass-through agreements provide a workable and mutually beneficial alternative to this frequently encountered scenario. By agreeing to pass through and prosecute the subcontractor's claim against the owner, the prime contractor can avoid the expense of litigating similar issues in separate proceedings, while minimizing the concomitant risk of inconsistent outcomes. More importantly, however, most pass-through agreements require the subcontractor to waive all or part

of its claims against the prime contractor in exchange for the contractor's assistance in prosecuting the subcontractor's claim against the owner. For example, subcontractors will frequently agree to accept whatever damages the prime contractor is able to recover from the owner in exchange for the contractor's agreement to prosecute its claim. Such agreements provide the subcontractor with not only an avenue to seek recovery from the owner, but also the ability to present a unified front against the owner with the contractor.

Severin Doctrine

The subcontractor must have a valid and recoverable claim against the prime contractor in order for a pass-through agreement to be enforceable. This requirement, known as the *Severin* doctrine, has its genesis in *Severin v United States*, a 1943 decision of the US Court of Federal Claims.⁽¹⁾ In *Severin* the prime contractor brought suit against the project owner for its own damages and the damages sustained by its subcontractor. Although the court allowed the prime contractor to recover its own damages, it held that the prime contractor was not entitled to recovery on the subcontractor's pass-through claim because the subcontract agreement provided that the prime contractor would not be liable to the subcontractor for "any loss, damage, detention or delay caused by the owner".

Subsequent decisions have tempered the harsh effects of the *Severin* doctrine which, when inflexibly applied, can result in a windfall for the owner. However, the *Severin* doctrine has not been erased from US construction law jurisprudence: it continues to influence the outcome of state and federal court rulings on pass-through claims. In order to avoid triggering application of the *Severin* doctrine, any waiver of the subcontractor's claims against the prime contractor that is inserted into a pass-through agreement should be conditional, not absolute, insofar as it preserves the subcontractor's right to recover from the prime contractor in the event that the contractor recovers from the owner.

Issues to Consider

Subcontractors should take care to avoid hastily liquidating viable claims against prime contractors without investigating the contractor's ability to prevail upon those claims against the owner. The owner cannot be held liable on the subcontractor's claims if it has a defence to claims brought by the prime contractor. For example, a waiver of consequential damages in the prime contract would defeat a subcontractor claim for consequential damages that is passed through the prime contractor to be brought against the owner. This would be true even if there were nothing in the subcontract or applicable law that would prevent the prime contractor from being liable to the subcontractor for consequential damages. In this regard, an improvidently entered into pass-through agreement can destroy an otherwise viable claim.

Similarly, prime contractors should investigate the validity of subcontractor claims before agreeing to pass them through to the project owner. Contractors can expose themselves to potential liability and penalties by prosecuting claims that are overstated, fraudulent or otherwise invalid. This concern is particularly acute in public works projects where the project owner is the US government and the claim exceeds \$100,000. In such cases the contractor has a statutory obligation to certify that:

- its claims are made in good faith;
- the supporting data is accurate and complete to the best of the contractor's knowledge and belief; and
- the contractor actually believes the government to be liable for the amount of the claim.⁽²⁾

In order to minimize the potential for disputes between the prime contractor and the subcontractor, the pass-through agreement should be reduced to a comprehensive written document that spells out the parties' rights and responsibilities. Pass-through agreements should:

- clearly delineate the claims that are to be passed through to the owner;
- contain a representation by the subcontractor that the claims are valid;
- indicate which party will fund the prosecution of the claims;
- indicate which party will control the litigation;
- contain a representation that the controlling party will use its best efforts to prosecute the claims successfully;
- spell out the role (if any) to be played by the non-controlling party;
- indicate which party has the right to accept a settlement offer;
- spell out the breadth of the liability release that the parties are willing to provide to the owner in order to reach a settlement;
- indicate how any settlement proceeds will be shared;
- specify the extent to which the subcontractor has waived or reserved its claims against the prime contractor; and
- identify how disputes arising from the pass-through agreement will be resolved.

Pass-through agreements are frequently made part of the record in trial and arbitration proceedings, both to establish the subcontractor's right to proceed on a pass-through basis and to facilitate the participation of its counsel in the proceedings. Therefore, such agreements should be drafted with disclosure in mind and couched in terms that show the existence of a legitimate business agreement rather than inappropriate collusion between the prime contractor and the subcontractor. Before negotiating the agreement, counsel for the parties should consider entering into a joint prosecution/common interest agreement to prevent, to the extent possible, their otherwise non-privileged communications concerning strategy and the prosecution of the claims from becoming discoverable by the owner.

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Endnotes

(1) 99 Ct Cl 435 (Ct Cl 1943).

(2) 41 USC § 605(c)(1).

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